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Stock Buybacks: Concerns over Debt-Financing and Long-Term Investing

A stock buyback occurs when a publicly traded firm repurchases some of its shares from investors with excess cash or borrowed funds. In recent years, the annual aggregate value of such repurchases has risen to historical highs, reaching nearly $1 trillion as firms such as Apple, Exxon Mobil, Microsoft, IBM, Visa, Citigroup, Cisco, Pfizer, Oracle, and Bank of America have conducted billion-dollar-plus stock repurchases. As aggregate buyback levels have soared, general scrutiny of them has intensified.

Legislation related to buybacks has also been introduced in Congress. S. 915 and H.R. 3355 would prohibit a firm from conducting a buyback. S. 2391 would ban buybacks unless they were accompanied by new buyback disclosure reforms. S. 2514 and H.R. 4419 would levy a tax on companies that did not distribute a worker "dividend" from their profits. The dividend's size could be based on the size of the company's recent stock buyback. As part of broad private equity fund reform, S. 2155 and H.R. 3848 would prohibit buybacks by firms in which a private equity fund has acquired a controlling interest.

Central concerns over buybacks are that they (1) represent a problematic short-term-oriented use of firm assets at the expense of longer-term investments; (2) are often exploited by senior executives for personal financial gain; and (3) are often debt-financed, which can increase firm vulnerability.

Others, however, emphasize that buybacks (1) can help signal that a company's stock is undervalued; (2) are often used to offset share dilution due to the issuance of new stock to accommodate stock- and stock option-based employee compensation programs; (3) represent the most financially prudent use of the cash used to finance them; (4) boost capital formation through shareholder reinvested cash proceeds; and (5) have greatly buoyed the current bull market, which is a hotly debated assertion.

Background

A firm's net income (also called net profit) is the remaining cash after operating expenses, interest, and taxes are deducted from its revenue. It is also the funding source for voluntary quarterly distributions to shareholders, known as *dividend payments*. A firm may also use its net income to buy back or repurchase its shares on the open market (the secondary stock market where shares are traded). Stock reacquired via a buyback is called *treasury stock* and is either permanently removed from stock-market circulation or retained by a company to be resold in the future.

Some publicly traded firms may not pay dividends or conduct buybacks. Some may conduct a buyback and pay dividends during the same period, while others may do one but not the other. A buyback and a dividend are similar in the sense that they both involve redistributing cash to shareholders. In contrast to buybacks, dividends have a much longer history and tend to represent an ongoing commitment to shareholders that firms are reluctant to stop for fear of sending a negative signal to securities markets. There is generally no expectation that firms will continually conduct buybacks.

In the past, dividend payments were larger than buybacks. But, over the past decade or so, the aggregate annual size of stock buybacks began to eclipse that of dividends and now greatly exceeds it. Scrutiny of buybacks also appears to have been heightened after the enactment of the 2017 tax revision (P.L. 115-97), sweeping tax legislation that resulted in overall corporate tax cuts. Historically robust dividend payments ensued, but the significant increases in buybacks got more media attention.

Firms in the widely followed S&P 500 stock index account for about 80% of overall domestic stock market capitalization and are also responsible for the vast majority of stock buybacks. In 2018, the firms in the index reached $800 billion in aggregate stock repurchases, a historical high. The Federal Reserve's Flow of Funds data on aggregate corporate net equity issuance (newly issued stock minus repurchased stock) is widely viewed as providing the most meaningful information on buyback trends. (Negative net issuance means that stock repurchases exceed stock issuances.) The data indicate that negative net equity issuance was at a historical high for nonfinancial firms between 2016 and 2018 (with the exception of the eve of the financial crisis in 2007), in the $500 billion range.

Perceived Undervaluation and Buybacks

The predominantly cited rationale for why firms conduct buybacks is that senior officials perceive that their company's stock is undervalued. Removing repurchased shares (absent newly issued stock) from the market diminishes the supply. Assuming that demand stays constant, in theory, the share price should rise. Complicating this dynamic, however, are instances when the securities market discounts a stock's price due to the removal of a valuable firm asset: the cash used to repurchase the stock.

The mere announcement of a buyback program, a large fraction of which are not implemented, is widely observed to often result in a short-term share price boost. Historically, however, firms have generally been inefficient at timing their buybacks when their share prices are advantageously low (for them, but not for their shareholders, who would prefer a buyout at higher prices).

Regulation 10b-18

Adopted in 1982 by the Securities and Exchange Commission (SEC), which regulates equity market trading, Rule 10b-18 gave companies a legal safe harbor when undertaking a stock buyback program by ensuring that firms that repurchase stock are not generally subject to legal liability for manipulation under the Securities and Exchange Act of 1934 (P.L. 73-291) when the volume of daily stock buybacks does not exceed 25% of the previous four weeks' average daily trading volume in company stock.

By various accounts, in the years after Rule 10b-18 went into effect, there has been significant growth in buybacks, annually dominated by a few large capitalized firms. According to Reuters, 60% of the approximately 4,000 publicly traded nonfinancial U.S. companies conducted buybacks between 2010 and 2014.

Leveraged Buybacks

Fostered in part by low interest rates, a large number of buybacks have been funded by debt and are known as *leveraged buybacks*. Data on the percentage of buybacks that are leveraged are inconsistent. For example, the bank J.P. Morgan Chase reported that leveraged buybacks accounted for 14% of overall buybacks during 2018, which it said was the lowest percentage since 2009. But Yardeni Research, a respected securities market research firm, reported that they were 56% of the total.

Whereas prudently managed corporate debt levels can be financially beneficial to firms, excessive levels can place them in financial jeopardy. And if corporate debt levels are systemically excessive, the overall economy may become destabilized. A 2019 article from Federal Reserve staff observed that aggregate nonfinancial corporate debt has been rising as a share of the aggregate book value of firms' assets, which it said represented a potentially troubling macroeconomic development. The principal uses of that increased debt, it noted, have been corporate acquisitions, stock repurchases, and dividend payments. However, it concluded that risks from the added debt were "mitigated in part by higher corporate cash flows."

Buybacks, Research and Development, and Long-Term Physical Capital Assets

For many firms, adequate expenditures on research and development (R&D) and long-term physical capital assets (CAPEX) are essential for long-term sustainability and growth. Various observers, including Members of Congress, individuals in the financial services industry, and some academics, have argued that funding buybacks (and sometimes dividends) problematically displaces spending on R&D and CAPEX.

Some critiques of buybacks, including a February 2019 *New York Times* editorial by Senators Chuck Schumer and Bernie Sanders, reference 2014 research that showed S&P 500 stock index firms who conducted buybacks and/or paid dividends tended toward using more than 90% of net income to fund them, leaving little room for R&D and CAPEX.

Related research from Lazonick et al, found that between 2006 and 2015, 18 leading pharmaceutical companies on the S&P 500 stock index spent 11% more on buybacks and dividends than on R&D. As a result, the study concluded that innovative existing drugs tend to be too costly and badly needed innovative drugs tend not to be produced.

Research by Gutierrez and Philippon in 2016 found that economic analysis indicated an overall investment gap across individual domestic firms. They partly attributed that underinvestment to firms opting for buybacks over investments. That same year, work by Lee, Shin, and Stultz examined individual firms in industries in which economic analysis indicated that their market value exceeded the value of their combined assets, suggesting that they should be investing more. The authors, however, found that the firms tended toward expanded buybacks, but weak spending on investments.

By contrast, some academics and members of the business community stress that buybacks represent a rational response to a firm's assessment that it lacks fiscally prudent new investment options. For example, New York University financial economist Aswath Damodaran has observed that many firms with the largest buybacks are in the late stages of their lifecycles and may have a diminished need for significant R&D and/or CAPEX.

In a 2018 article in the *Harvard Business Review*, Wang and Fried observed that buybacks and dividends among S&P 500 firms between 2007 and 2016 were 96% of their excess cash (often used interchangeably with net income). But the two wrote that this is misleading because the firms' net shareholder equity payouts—combined company distributed and repurchased equity from dividends and buybacks—were a far less burdensome 50% of excess cash. Wang and Fried also examined CAPEX and R&D as a percentage of revenue (a commonly used metric of corporate investment intensity) for S&P 500 firms over the past quarter of a century. They found that, although it was highly volatile on a year-to-year basis, it has been rising over the past decade, and is close to its peak levels during the late 1990s.

A 2017 Federal Reserve staff study found that aggregate firm data both in and outside of the United States appeared to provide limited evidence that large shortfalls in overall corporate investments have been associated with large increases in share buybacks and/or dividends. However, it also indicated that this was far from conclusive and that more research was needed, particularly at the firm level.

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CRS Legal Sidebar LSB10266, *Stock Buybacks: Background and Reform Proposals*, by Jay B. Sykes.

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